

VZCZCXRO8448  
RR RUEHDBU RUEHLN RUEHVK RUEHYG  
DE RUEHEK #0021/01 0160829  
ZNR UUUUU ZZH  
R 160829Z JAN 07  
FM AMEMBASSY BISHKEK  
TO RUEHC/SECSTATE WASHDC 8812  
INFO RUCNCIS/CIS COLLECTIVE  
RUEHLM/AMEMBASSY COLOMBO 0003  
RUEHKA/AMEMBASSY DHAKA 0016  
RUEHIL/AMEMBASSY ISLAMABAD 0481  
RUEHBUL/AMEMBASSY KABUL 0292  
RUEHKT/AMEMBASSY KATHMANDU 0013  
RUEHNE/AMEMBASSY NEW DELHI 0169  
RUCPCIM/CIMS NTDB WASHDC  
RUEATRS/DEPT OF TREASURY WASHDC  
RUCPDOG/USDOC WASHDC 0541

UNCLAS SECTION 01 OF 08 BISHKEK 000021

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DEPT FOR SCA/CEN (GEHRENBECK), EB/IFD/OIA (HATCHER)  
DEPT PASS TO USTR

E.O. 12958: N/A

TAGS: [EINV](#) [EFIN](#) [ETRD](#) [ELAB](#) [KTDB](#) [OPIC](#) [USTR](#) [KG](#)

SUBJECT: 2007 INVESTMENT CLIMATE STATEMENT FOR THE KYRGYZ  
REPUBLIC

REF: 06 STATE 178303

11. This cable provides Embassy Bishkek's submission of the  
2007 Investment Climate Statement for the Kyrgyz Republic.

12. Begin text:

Openness to Foreign Investment  
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The Kyrgyz Republic has a liberal investment regime with a broad base of commercial laws. Unfortunately, these laws are not implemented consistently. Foreign investors must register their firms with the Ministry of Justice. In addition to registration, expatriate employees must obtain a work permit from the State Committee on Migration and Employment. Foreign investors usually form joint ventures with local partners, a step which has proven to be the most successful strategy to date.

The legal concept of contract sanctity is not consistently observed. Kyrgyz law on foreign investment guarantees protection for foreign investors from expropriation and nationalization. Individual investors have become involved in disputes over licensing, registration, and enforcement of contracts. Corruption is also a serious problem, although the Government of Kyrgyzstan (GOKG) has publicly denounced corruption and implemented some steps to counter this problem. In June 2002, Parliament passed the Law on Commercial Arbitration, creating a mechanism for expeditious resolution of commercial disputes. This mechanism, the Commercial Arbitration Court of Kyrgyzstan, opened in October 2002 and began considering cases in April 2004.

Banking laws do not discriminate against foreign banks. Eight foreign banks operate in the Kyrgyz Republic: Demir Bank (Turkey), Bank of Asia (South Korea), National Bank of Pakistan, EnergoBank (90% owned by the Kazakh ATF Bank), Halyk Bank (Kazakhstan), the Kyrgyz Investment and Credit Bank (owned mostly by international public and private development institutions), FinanceCreditBank (Kazakhstan) and KyrgyzCredit Bank (under Italian control).

There is no discrimination against foreign investors enshrined in official government policy. However, procedures for licensing and approvals are not transparent, which can

make the process seem discriminatory. Tax authorities may apply greater scrutiny to foreign entities operating in the Kyrgyz Republic.

#### Conversion and Transfer Policies

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Foreign exchange is widely available, and the local currency, the som, is freely convertible. The National Bank of the Kyrgyz Republic (NBKR) conducts weekly inter-bank currency auctions, in which competitive bids determine market-based transaction prices. Banks clear payments within a single working day.

Few foreign businesses complain of currency conversion issues. Some Kyrgyz entities, particularly in the agricultural sector, are strapped for cash and thus engage in cashless barter transactions. The government has recognized the need to phase out barter transactions. Payment disputes adjudicated through the court system can be extremely lengthy.

In 2000 and 2001, several Kyrgyz banks declared bankruptcy, lost their licenses or were restructured. Depositors at these banks lost significant sums. The government does not guarantee or insure deposits with Kyrgyz banks. No bank closures have occurred since 2001.

#### Expropriation and Compensation

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To date, the Kyrgyz government has not expropriated any properties. However, in 2006, local officials assisted in

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the seizure of equipment and other property of one foreign investor. Foreign investors have the right to compensation in the case of government seizure of assets. However, there is little understanding of distinctions among historical book value, replacement value and actual market value, which brings into question whether the government could calculate a fair basis for compensation in the event of expropriation. The government has frozen bank accounts and other liquid assets until disputes were resolved. In anecdotal cases, government officials have hinted at nationalization in disputes with foreign firms.

Foreign ownership of land continues to be prohibited. Prior to an October 1998 referendum that introduced private land ownership, Kyrgyz citizens were also prohibited from owning land. While foreign ownership of land is still forbidden, there is no prohibition on foreign rental of land for residences or factory sites. A central land registry has helped potential lenders and others deal with the financing of real property (e.g., land, buildings, and other improvements) in a more sophisticated manner.

#### Dispute Settlement

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The Law on Commercial Arbitration allows for international and domestic arbitration of disputes. If feasible, the arbiter should be a neutral entity that is identified in the contract, along with the specific terms of arbitration. Establishing the terms for arbitration beforehand will prevent further complications in the event of a dispute. The Kyrgyz Republic is a member of the International Center for the Settlement of Investment Disputes (ICSID). It signed the ICSID agreement on June 9, 1995, and ratified it on July 5, 1997. The Kyrgyz Republic became a member of the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards on March 18, 1997.

#### Performance Requirements and Incentives

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Former tax holidays and other incentives for foreign

investors have been eliminated in accordance with standards preferred by international financial institutions and as a requirement of the Kyrgyz Republic's entry into the World Trade Organization (WTO). The Kyrgyz Republic is compliant with WTO Trade Related Investment Measures obligations. The Kyrgyz government has also reduced the tax burden on repatriation of profits by foreign investors to conform to the tax rate for domestic investors. There are no specific conditions for permission to invest. However, any project is likely to be scrutinized for its effect on employment and tax revenues.

Visa requirements and fees may change on short notice. In 2006, the Kyrgyz government adopted a measure limiting the period expatriates can work in Kyrgyzstan. Government ministries, lacking adequate budgets, often finance their operations through user fees. Such fees may appear arbitrary.

The Kyrgyz Government is in the process of overhauling its tax code. A consortium of government officials, business leaders and outside experts are reviewing the current tax code to address the legislation's shortcomings, improve the tax administration process, rationalize the rate structure and make the tax system more investment friendly. The new tax code might be adopted in 2007.

Taxes are complex, although the new tax code is supposed to improve the situation. Some of the existing taxes involve complex and time-consuming accounting. Payroll taxes such as social fund payments, used for the National Pension System, are also complex. Many recent tax inspections have focused on social fund payments. Transparency is a problem, as even basic laws, tax rates, and regulations are seldom published.

#### Right to Private Ownership and Establishment

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Foreign and domestic private entities may own business

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enterprises and engage in a broad range of commercial activities. Foreign entities are expressly forbidden from owning land, including farmland, although regulations allow for up to 99-year leases of property, which is adequate for most business purposes. A law regulating foreign ownership of houses, apartments, and other structures has been repealed, leaving the rights of foreigners to own such properties unclear.

Foreign investors are theoretically given equal treatment under Kyrgyz law. In reality, well-connected Kyrgyz private or state-owned companies are able to utilize their contacts to achieve their business aims. Foreign investors are disadvantaged less by outright discrimination than by a simple lack of knowledge on how to "work the system."

#### Protection of Property Rights

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Property right protections are slowly emerging. However, the judicial system remains under-developed and lacks independence. Court actions can force the sale of property to enforce payments and other contractual obligations. Laws on collateral and bankruptcy make the enforcement of commercial obligations increasingly viable and more widely respected. A central lien registry, now functioning, also reduces disputes over collateral.

The Kyrgyz Republic is obligated to protect intellectual property rights as a member of the WTO. However, an estimated 80% of DVDs, CDs and other audio-visual products sold in the Kyrgyz Republic are counterfeit. The Kyrgyz Republic acceded to both the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty in 2002.

#### Transparency of the Regulatory System

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The legal and regulatory system of the Kyrgyz Republic continues to develop. The process of implementing regulations and court orders relating to commercial transactions remains inconsistent. The Kyrgyz system is heavily bureaucratic. Consequently, investors must overcome a great deal of red tape in order to conduct business.

The GOKG established a "one stop shop," recently shifted to the Ministry of Finance, to guide investors through the government bureaucracy. The ability of this office to steer firms through the system has not been fully demonstrated. Contradictory government decrees often create bureaucratic paralysis or opportunities for undocumented incentives.

#### Efficient Capital Markets and Portfolio Investment

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The National Bank of the Kyrgyz Republic increasingly favors modern financial practices. The currency is freely convertible, Kyrgyz bonds are available for foreign ownership, and the stock market is developing.

In December 2006, the stock market listed 14 companies, all adhering to international accounting standards. There were also approximately 500 unlisted companies trading at the exchange weekly. (The unlisted firms either have not maintained a transparent accounting system for the previous three years, or refuse to disclose their financial records.) The 2005 total trade volume was 1,745 transactions for 51,008,715 shares valued at 1,245,809,389 soms (approximately \$30,385,594).

From January 1 to September 30, 2006, the total trade volume was 1,709 transactions for 111,414,663 shares valued at 1,796,038,000 soms (approximately \$ 47,264,157). Although most shares are still traded over the counter, a new computerized central depository for shareholder information has simplified trades and record keeping.

Total capitalization of the banking sector as of January 2006 was about \$ 64,331,637. There are currently 21 commercial

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banks in the Kyrgyz Republic, with a total of 171 branches throughout the country.

Several foreign banks now operate in the Kyrgyz Republic. Demir Bank, Bank of Asia, National Bank of Pakistan, Halyk Bank, Kazcommerce Bank and FinanceCredit Bank are entirely foreign held. Other banks are partially foreign held, including the Asia Universal Bank (70% foreign held) and KICB (Kyrgyz Investment and Credit Bank). Although no U.S. bank has set up operations in the Kyrgyz Republic to date, many Kyrgyz banks maintain correspondent relations with U.S. and other foreign banks to facilitate short-term commercial lending, such as letters of credit.

The Kyrgyz Investment and Credit Bank (KICB) began operating in mid-2001. Established to provide commercial lending and other services, the KICB introduced western banking practices and encouraged the entry of other banks into the Kyrgyz market. KICB's principle shareholder is the Aga Khan Fund for Economic Development, which has a 30% stake. The International Finance Corporation, the European Bank for Reconstruction and Development, and the German Bank for Reconstruction and Development each hold 20% stakes. The GOKG retains a 10% share.

The Kyrgyz Republic is largely a cash society, and outside investors have rarely sought financing from domestic banks. Bank lending is heavily biased towards short-term loans and traditionally has not favored using physical assets as collateral. Some banks ignore retail banking, and instead focus on government bonds.

Since October 1999, new banks must have a minimum charter capital requirement of 300 million soms (\$7.7 million).

As of January 1, 2006, the minimum owned capital requirement (charter capital plus or minus profit or losses) was set at no less than 60 million soms (\$1.5 million). Banking laws also require that banks maintain a 10% reserve with the National Bank. No deposit insurance or government guarantee of deposits currently exists, although plans for such a system have been outlined.

Between 1999 and mid-2001, seven banks became insolvent and suspended operations. No bank closures have occurred since 2001. The Supreme Court, in 2005, ruled against the National Bank's attempt to declare the commercial bank, "AkBank," bankrupt.

Accounting systems in banks and enterprises are rapidly being converted to international standards. The Kyrgyz government has supported this exercise. International assistance programs have contributed to rapid progress in reaching these standards via accounting training and certification. The National Bank of the Kyrgyz Republic is trying to impose strict regulation on the banking system, and is also working to improve commercial accountability. The closure of weaker banks has made the banking sector stronger and more viable as a whole.

#### Political Violence

In March 2005, a popular uprising led to the overthrow of President Askar Akayev. The change of power was precipitated by smaller uprisings in southern Kyrgyz towns, such as Osh and Jalalabad, in which citizens rallied against perceived flaws in earlier parliamentary elections. The uprising was swift and largely bereft of serious violence, but witnessed substantial looting and numerous minor injuries. Three people reportedly died during the unrest. Losses due to looting in Bishkek are estimated at almost \$100 million. Kurmanbek Bakiyev was elected president in July 2005.

Outside of the March 2005 uprisings, there have been no recent incidents of politically motivated damage to projects and installations. Demonstrations in November 2006, which resulted in a new constitution, were largely peaceful. Kyrgyz citizens enjoy basic rights, including the right to

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protest and demonstrate. Although Kyrgyz citizens have exercised these rights more freely than citizens in nearby countries, the GOKG occasionally restricted these rights in the past.

Supporters of extremist groups such as the Islamic Movement of Uzbekistan (IMU), Al-Qaeda, and the Eastern Turkistan Islamic Movement remain active in Central Asia. These groups have expressed anti-U.S. sentiments and may attempt to target U.S.-affiliated interests in the region, including in the Kyrgyz Republic. Because of increased security at official U.S. facilities, terrorists seek softer civilian targets such as residential areas, clubs, restaurants, places of worship, hotels, schools, outdoor recreation events, resorts, beaches, maritime facilities and planes. In December 2002, a bombing occurred at the Dordoi Bazaar, a market mostly frequented by locals. In May 2003, a bank in Osh was bombed. The Kyrgyz Government blamed the IMU for both bombings.

In May 2006, suspected Islamic militants attacked a border post on the Kyrgyz-Tajik border, and ensuing skirmishes took place between the militants and Kyrgyz military forces throughout the southern Batken region. U.S. citizens planning to travel to the Kyrgyz Republic should refer to the U.S. Department of State for updated security information. This information is available on the Internet at <http://travel.state.gov>.

In the summers of 1999 and 2000, armed IMU insurgents entered the southern Kyrgyz Republic and took a number of Kyrgyz citizens and foreigners captive. While subsequent military operations in Afghanistan have eliminated many resources used by these insurgents, the Department of State urges U.S. citizens to avoid travel to the following areas of the Kyrgyz Republic: the rural areas along the Kyrgyz-Uzbek and Kyrgyz-Tajik borders, and the areas to the south and west of the provincial capital Osh.

There are occasional tensions among ethnic Kyrgyz, Russian, Uzbek and other ethnic nationalities in the Kyrgyz Republic over such issues as language, land rights, and religion. North-south divisions are also palpable in the Kyrgyz Republic. Such tensions, however, seldom affect foreign employers directly. The Kyrgyz Republic's relations with its neighbors sometimes are complicated over disagreements regarding water rights, energy payments, refugees, and other issues. However, it is unlikely that such tensions would translate into disputes directly affecting foreign investors.

#### Corruption

Corruption permeates life in the Kyrgyz Republic. U.S. firms complying with the Foreign Corrupt Practices Act can be disadvantaged vis-a-vis other foreign firms operating in the Kyrgyz Republic. However, most U.S. firms that have resolved to conduct business in the Kyrgyz Republic have eventually been able to do so. To date, measures targeting bribery and other such economic crimes have been selectively enforced, typically against persons perceived as political enemies of the government.

The Kyrgyz Government is taking measures to address rampant corruption in the country. As part of its IMF Poverty Reduction and Growth Facilitation program, the GOKG has agreed to take action to stem corruption. On June 29, 2005, the Parliament of the Kyrgyz Republic ratified the UN Convention Against Corruption. In 2004, the Kyrgyz Government founded the National Council for Good Governance, which is tasked with tackling corruption. While the Council has yet to take significant steps to address the problem, the government is working closely with international financial institutions, international donors and non-governmental organizations to develop a plan to concrete plan to fight corruption. Following the 2005 overthrow of the Akayev regime, the new government opened 106 criminal cases against the Akayev family's business interests. However, in October 2006, the Kyrgyz Deputy General Prosecutor acknowledged that a number of the criminal cases were groundless and merited dismissal. As of January 2007, investigations into the

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remaining cases continued.

The Ministry of Internal Affairs (i.e., the police) and the National Security Service (i.e., the successor to the KGB) are responsible for investigating corruption, together with the Prosecutor General and subordinate prosecutors. Kyrgyz law enforcement officers received integrity awareness training under a U.S. government-sponsored anti-corruption program in August 2001. The government has also created special police anti-corruption units. However, they have yet to show their effectiveness.

The Kyrgyz Republic is not a signatory to the OECD Convention on Combating Bribery. However, the OECD and the World Bank have previously reported on the progress of anti-corruption measures.

U.S. and third-country firms have identified corruption as a major obstacle to foreign investment. While bribing a government official is technically a criminal act, there have been no recent prosecutions of this crime. Corruption is

found in every aspect of a company's interaction with the government, including licensing, dispute settlement, government procurement, regulatory activity, and taxation. All levels of government appear to be afflicted by corruption and allegations of corruption.

#### Bilateral Investment Agreements

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The Kyrgyz Republic currently enjoys bilateral investment treaties with the United States, Armenia, Azerbaijan, Belarus, China, Finland, France, Georgia, Germany, India, Indonesia, Iran, Kazakhstan, Malaysia, Moldova, Mongolia, Pakistan, Sweden, Switzerland, Tajikistan, Turkey, United Kingdom, Ukraine and Uzbekistan.

The Kyrgyz Republic has also signed double taxation treaties with Armenia, Austria, Belarus, Canada, Finland, Germany, India, Kazakhstan, Malaysia, Mongolia, Pakistan, Poland, Russia, Switzerland, Tajikistan, Turkey, Ukraine, and Uzbekistan. The U.S.-U.S.S.R. treaty on double taxation, which was signed in 1973, remains in effect between the U.S. and the Kyrgyz Republic.

#### OPIC and Other Investment Insurance Programs

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OPIC is currently active in the Kyrgyz Republic. The event of an inconvertibility claim against OPIC is highly unlikely, given the Kyrgyz Republic's liberal conversion regime. As of December 2006, the local currency, the som, had a conversion rate of 38.6 soms per U.S. dollar. The exchange rate is market-based. According to the Bulletin of the National Bank, the Kyrgyz Republic's Consumer Price Index (CPI) reached 4.9% in 2005, and is estimated to have been 4% in 2006.

#### Labor

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Labor is widely available, but the number of skilled individuals is decreasing as Kyrgyz citizens find more lucrative job opportunities abroad. International organizations are generally able to employ competent staff, often bilingual in English or other languages, but are starting to encounter difficulties retaining staff members. Literacy in the Kyrgyz Republic is approximately 97 percent. The Employment Department under the Labor Ministry reports that, as of October 2006, the official unemployment rate was 17.7 percent. The unemployment rate would actually be higher if neighboring countries and Russia did not absorb many migrant workers.

#### Foreign Trade Zones/Free Ports

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There are four Free Economic Zones (FEZs) in the Kyrgyz

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Republic: Bishkek, Naryn, Karakol and Maimak. Each is situated to make use of transportation infrastructure and/or customs posts along the Kyrgyz borders. Goods entering and traded within the zones are duty free within the Kyrgyz Republic. Government incentives for investment in the zones include exemption from several taxes, duties and payments; exemptions from some import and export duties; simplified customs procedures; and direct access to utility suppliers. The production and sale of petroleum, liquor, and tobacco products in FEZs is banned.

#### Foreign Direct Investment Statistics

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According to the Kyrgyz National Statistical Committee, Foreign Direct Investment (FDI) totaled \$210.3 million in

2005, \$176 million in 2004, \$147 million in 2003, \$116 million in 2002 and \$90 million in 2001. For the first nine months of 2006, FDI amounted to \$189.5 million. Government statistics are generally accurate regarding inflation and price levels. However, the problem of registering and tracking numerous new private businesses has rendered statistics on employment, the tax-base and national economic performance less accurate. The shadow economy may account for up to one-half of overall economic activity.

Foreign direct investment is chiefly oriented towards manufacturing, food processing, banking, mining, trade, restaurant services, transportation and communications. Many foreign firms conduct contract work for foreign assistance organizations. U.S. direct investment is concentrated in the hotel and telecommunications sectors, with increasing interest in construction and mining.

Joint ventures and foreign companies in the Kyrgyz Republic include the Reetsma Kyrgyzstan Company (cigarettes), the Plaskap Bishkek Company (packaging/bottling), the Central Asian Group (entertainment/garments), the Hyatt Regency Bishkek, and the Kyrgyz Petroleum Company. A U.S.-Turkish-Dutch joint venture operates a Coca-Cola franchise that bottles its soft drinks locally, and the Canadian gold-mining firm Centerra Gold has formed the largest western joint venture in the Kyrgyz Republic, the Kumtor Operating Company. Joint ventures play a leading role in the mining, petrochemical, hotel, and food processing sectors.

According to the National Statistical Committee, the following countries were the largest sources of FDI in 2005: Germany 17.33%, Great Britain 14.02%, Canada 12.43%, Turkey 7.66% and USA 5.57%. Data for 2006 are not yet available. However, Kazakh entrepreneurs are investing heavily in Kyrgyzstan, and have substantial stakes in the financial services and tourism sectors.

Bishkek and the surrounding Chui region absorbed more than 70% of FDI in 2005. An additional 13% went to the Issyk Kul region, with the remaining amounts scattered among the other five regions of the country.

#### General -----

In connection with the war on terrorism, a Coalition airbase operates out of the Manas International Airport near Bishkek. In the most recent fiscal year ending September 2006, base payments to companies employing Kyrgyz staff totaled nearly \$90 million.

The capital city of Bishkek has an international English-language elementary school and other services for expatriate families. The Hyatt Regency is the only five-star hotel. The Golden Dragon is a four-star alternative. There are several three-star hotels in Bishkek, including the British-owned Silk Road Lodge. There are direct air connections to Istanbul and London. Other cities, such as Amsterdam, Vienna and Frankfurt, are served from Almaty, Kazakhstan, a three-and-a-half hour drive from Bishkek.

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End text.

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